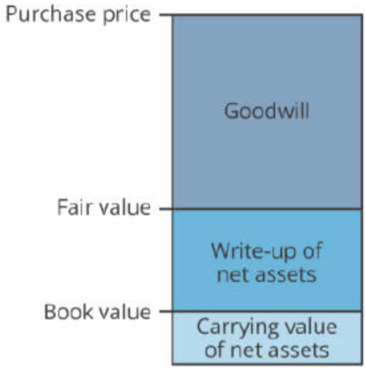
8.02 Goodwill

Overview

Goodwill is known as the unidentifiable intangible since its value cannot be directly determined. It is, however, represented by the excess of what a buyer is willing to pay for a business over and above the value of the net identifiable assets on the books of the acquired company.

Since it is impossible to verify the value of goodwill in the absence of an actual transaction, it may only be recorded on the balance sheet when it results from the purchase of another business. A company may not record as goodwill the internal costs of developing or restoring it.

Initial value of goodwill



Measuring Goodwill

If one entity acquires 100% of another entity, it is assumed that the fair value of the consideration given is the fair value of the entity reported. That amount will be compared to the net of:

+ The fair value of all identifiable tangible and intangible assets acquired, which may include assets that are not on the financial statements of the acquired entity, minus

– The fair value of all liabilities assumed

In most cases, the fair value of the consideration given will exceed the fair value of the underlying net assets, in which case the difference would be goodwill. In rare circumstances, the fair value of the underlying net assets exceeds the fair value of consideration given, in which case the difference is recognized as a gain on bargain purchase by the acquiring entity.

Assume one entity acquires all of the stock of another entity for $1,000,000. The acquired entity has the following assets and liabilities:

	Book value	Fair value
Current assets	$ 350,000	$ 350,000
Plant and equipment, net	600,000	850,000
Intangibles, excluding goodwill	0	100,000
Total identifiable assets	$ 950,000	$ 1,300,000
Liabilities assumed	500,000	500,000
Value of underlying net assets	$ 450,000	$ 800,000
Total consideration		1,000,000
Goodwill		$ 200,000

In a business combination, goodwill is assigned to one or more reporting units. A reporting unit can be an operating segment or one level below. The amount assigned to an individual reporting

unit is the excess of the fair value of that reporting unit over the fair value of the net underlying assets in the reporting unit.

There are a couple of ways to account for the acquisition: as a merger or an investment.

- **Merger** – The acquired entity (acquiree) may be **integrated into the acquiring entity** (acquirer) without maintaining separate books and records for the acquired entity.
    - The assets and liabilities of the acquiree, including goodwill, are recorded on the books and records of the acquirer.
    - The entity, as a whole, is considered the reporting unit with the goodwill.
- **Investment** – The acquirer will recognize an investment in subsidiary on its books and may **maintain separate books and records** for the acquiree.
    - Consolidated financial statements will be prepared each period.
    - The acquiree will be considered the reporting unit with the goodwill.
- **Investment with multiple reporting units** – The acquirer may not only maintain separate books and records for the acquiree but may actually maintain more than one set of books and records for the acquiree if the acquiree consists of more than one department, operation, or other natural business unit. For example, the acquiree may maintain separate units for a research division, a manufacturing division, and a sales and distribution division.
    - Each division would be considered a separate reporting unit.
    - Goodwill would be allocated among the reporting units based on the differences between the value of each reporting unit and the fair value of its underlying net assets.

Ways to Account for Acquired Company & Goodwill			
Method	**Sets of Books**	**Reporting Unit(s)**	**Goodwill Treatment**
Merger – Acquiree is integrated into acquirer	1	Acquirer	Recorded on books of acquirer
Investment – Acquiree is recognized as investment in a subsidiary • Consolidated financial statements	2	Acquirer & Acquiree	Allocated to acquiree
	3 or more	Acquirer & Acquiree reporting unit 1, 2, etc.	Allocated between reporting units of acquiree

Impairment

Goodwill has an indefinite useful life and, similar to other intangibles with indefinite useful lives, it is **tested** for impairment at least **annually**. Goodwill is considered impaired when the carrying value of the reporting unit with which it is associated exceeds that reporting unit's fair value. The goodwill associated with each reporting unit is required to be evaluated separately.

Interim Testing

In addition to the annual impairment tests, the entity may have reason to believe that goodwill has been impaired between impairment dates. If the entity does determine that it is more likely than not that goodwill has been impaired between the most recent evaluation date and the date of the financial statements, an additional interim impairment test will be performed.

Optional Qualitative Assessment

Various qualitative factors can be evaluated to determine whether it is *more likely than not* that the carrying value of a reporting unit exceeds its fair value, indicating that goodwill may be impaired.

- Macroeconomic conditions, such as general limitations on the availability of capital
- Industry and market considerations, such as an increase in the competitive environment
- Cost factors, such as increases in the costs of raw material or labor
- Overall financial performance, such as declining profits or cash flows
- Events specific to the entity, such as changes in management
- Events affecting the reporting unit, such as a change in the composition of its assets
- In some cases, a sustained decrease in the price of shares of stock
- Other relevant events or circumstances that affect a reporting unit's carrying value or fair value of net assets

Quantitative Impairment Test

If the optional qualitative assessment above indicates that goodwill is *unlikely* (ie, less than 50% chance) to be impaired, then further testing is not required. If, however, the qualitative assessment indicates that goodwill is more likely than not impaired, or the qualitative assessment is not performed, then a *quantitative assessment* of goodwill (ie, impairment testing) is required.

Goodwill is tested for impairment by comparing the carrying value of the reporting unit (including goodwill) to its fair value. The carrying value of the reporting unit will be known to the entity since it is the amount reflected in the books and records being maintained for the reporting unit. The fair value will represent the amount that the entity would be able to sell the reporting unit for in an orderly transaction between market participants.

- If the fair value of the reporting unit is equal to, or greater than, its carrying value, it is generally assumed that goodwill is not impaired.
  - Note that deferred taxes are included in the carrying value of a reporting unit.
- If, however, the carrying value of the reporting unit is greater than the fair value, there is an impairment loss equal to the excess of the carrying value over the fair value, but it is limited to the amount of goodwill recorded.
  - Note that any other assets subject to impairment testing at the same time should be tested and written down, if necessary, prior to testing goodwill.

Once goodwill has been written down due to impairment, the adjusted amount becomes the goodwill's new carrying value. This amount is used for comparison in future assessments. Even if it is later determined that goodwill has increased in value, **recoveries are not recognized**.

Impairment loss (I/S – continuing ops)	X	
Goodwill		X

In a business combination, Push Corporation acquired all of the outstanding stock of Shove, Inc. for $7,500,000 at a time when Shove's underlying net assets had a fair value of $6,900,000 in the transaction. As a result, **goodwill of $600,000** was recognized. Push maintains separate accounting records for Shove, which is considered a separate reporting unit.

During the current period, due to some very aggressive marketing tactics, Shove's reputation was damaged, and Push has determined that it is more likely than not that the goodwill has been impaired. As a result, Push will perform a quantitative impairment test in relation to Shove's goodwill. Push will compare Shove's carrying value (CV) to its fair value (FV).

- The carrying value on the date of the test is readily determinable from the separate accounting records being maintained:

Cash	$ 350,000
Accounts receivable	1,250,000
Inventories	3,000,000
Other current assets	200,000
Plant and equipment	5,750,000
Intangibles	2,000,000
Goodwill	600,000
Total	$13,150,000
Current liabilities	(950,000)
Long-term debt	(4,100,000)
Carrying value of reporting unit	$ 8,100,000

- The fair value, determined using an appropriate valuation technique, most likely employing the same approach(es) used to determine how much Push would originally purchase Shove for, turned out to be $7,900,000.
- $8,100,000 CV – $7,900,000 FV = $200,000 impairment loss

Goodwill would be written down from $600,000 to $400,000, and an impairment loss of $200,000 would be recognized in income.

Impairment loss (I/S – continuing ops)	200,000	
Goodwill		200,000

Accounting Alternatives for Certain Nonpublic Entities (Goodwill)

To reduce the cost and complexity associated with frequent impairment testing, there are **two approaches** available to **private** companies and **not-for-profit organizations**. Eligible entities can elect to follow one or both alternatives.

First Alternative

This option allows eligible entities to **amortize goodwill**.

- Goodwill will be amortized on a **straight-line basis** over its **useful life**, not to exceed **10 years.** Since goodwill will be amortized, the carrying value decreases each period, making it less likely that goodwill will be impaired.
- Like a public entity, however, goodwill is still tested for impairment if a triggering event occurs indicating that the fair value of the entity (or reporting unit) has fallen below its carrying value.
- Eligible entities may perform a *qualitative assessment* to determine if it is "more likely than not" (ie, greater than 50% probability) that goodwill has been impaired. If this assessment indicates impairment is unlikely, no further testing is required. If it reveals that goodwill is more likely than not to be impaired, goodwill is tested for impairment (ie, *quantitative assessment*).
- Entities that elect this alternative have the option of performing **impairment tests** at the **entity** level **or** the **reporting unit level**. If the entity level is elected, the entity will combine all components of goodwill and perform a one-step impairment test for the entity as a whole.
  - The fair value of the entity is compared to its carrying value. If the fair value is lower than the carrying value, the difference is attributed to goodwill and recognized as an impairment loss.
  - Since goodwill cannot be reduced below zero, if the amount of the impairment loss exceeds the carrying value of goodwill, the entity must evaluate its other assets to determine whether additional impairment losses should be recognized.

Second Alternative

This option **reduces frequency** of goodwill impairment testing.

- Triggering events generally must be monitored and evaluated *throughout* the reporting period. However, under this alternative, eligible entities are allowed to effectively test for triggering events and impairment only *once*, as of the **end** of each **reporting period**.
  - The end of a reporting period can be either an annual or interim (eg, quarterly) period.

Disclosure Requirements

The selection to use either (or both) of these accounting alternatives and the selection to test impairment at the entity level is disclosed in the *Summary of Significant Accounting Policies*.